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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934

No. 826

GEORGE W. McCANDLESS, as Receiver of Duquesne Gas Corporation,
Petitioner (Plaintiff-Appellee-Appellant Below),
against
MAXIME H. FURLAUD and KINGSTON CORPORATION,
Defendants-Appellants-Appellees Below,
and
BYRON CORPORATION and CHAUCER CORPORATION,
Defendants-Appellees Below,
and
CARLOS REUTER,
Defendant Below.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

RALPH ROYALL,
WILLIAM A. MAGEE and
CLARK MILLER,
Counsel for Petitioner.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1934

No.

GEORGE W. MCCANDLESS, as Receiver of Duquesne Gas Corporation,
Petitioner (Plaintiff-Appellee-Appellant Below),
against
MAXIME H. FURLAUD and KINGSTON CORPORATION,
Defendants-Appellants-Appellees Below,
and
BYRON CORPORATION and CHAUCER CORPORATION,
Defendants-Appellees Below,
and
CARLOS REUTER,
Defendant Below.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Charles E. Hughes, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

George W. McCandless, as Receiver of Duquesne Gas Corporation, plaintiff-appellee-appellant below, the above

named petitioner, respectfully prays that a writ of certiorari issue to review the decree of the United States Circuit Court of Appeals for the Second Circuit, filed on the 11th day of March, 1935, reversing the final decree filed in the United States District Court for the Southern District of New York on the 11th day of May, 1933, which awarded a judgment to plaintiff against the defendants Maxime H. Furlaud and Kingston Corporation in the sum of $1,834,640.08.

STATEMENT

This is a suit brought by the petitioner as plaintiff in his capacity as ancillary receiver of Duquesne Gas Corporation, appointed as such in the District Court of the United States for the Southern District of New York (R. 5-7). After a trial before United States District Judge Knox, a decree was made awarding judgment to the plaintiff against the defendants Maxime H. Furlaud and Kingston Corporation in the sum of $1,834,640.08 and dismissing the complaint as to the defendants Byron Corporation and Chaucer Corporation (R. 339-40). The defendant Carlos Reuter was not served with process and did not appear (R. 1).

The defendants Maxime H. Furlaud and Kingston Corporation appealed from such decree to the Circuit Court of Appeals, Second Circuit, and the plaintiff took a cross appeal claiming that judgment should be awarded against each of the defendants Byron Corporation and Chaucer Corporation in the sum of $425,000 with interest, and also that the judgment against the defendants Maxime H. Furlaud and Kingston Corporation should be increased by the amount of $850,000 with interest.

Upon the appeal the defendants Maxime H. Furlaud and Kingston Corporation raised for the first time the question of the plaintiff's right to sue. The claim of these defendants was that the appointment of the plaintiff as ancillary receiver in the District Court for the Southern District of New York was void and that such appointment could be collaterally attacked and that the judgment which had been granted in favor of the plaintiff as such ancillary receiver should be vacated and set aside. The Circuit Court of Appeals adopted this view and by a decree dated the 8th day of January, 1934, reversed the judgment.

On the petition of the plaintiff, the Supreme Court granted a writ of certiorari to review the decree of the Circuit Court of Appeals dated the 8th day of January 1934, and limited such writ to the review of the questions relating to the validity of the appointment of the ancillary receiver (292 U. S. 617; 78 L. Ed. 1475). Upon the appeal, pursuant to the writ, the Supreme Court reversed the Circuit Court of Appeals and held that the validity of the appointment of the plaintiff as ancillary receiver could not be first questioned on appeal and directed a rehearing of the appeal in the Circuit Court of Appeals for the determination of the questions relating to the liability of the defendants decided by the District Court* (79 L. Ed. 32).

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*The opinion of the Circuit Court of Appeals upon the rehearing erroneously states in the second paragraph thereof:

> "A receiver was appointed for the Duquesne Gas Corporation in the United States District Court for the Western District of Pennsylvania, and he sued in the District Court for the Southern District of New York, without appointment therein as an ancillary receiver. We reversed the decree, on a former appeal, for failure to have an ancillary receiver appointed in the Southern District of New York before suit (68 Fed. 2, 925). The Supreme Court reversed (79 Law. Ed. 32) remanding the cause to this court to pass upon the merits of the issues presented."

Upon a rehearing pursuant to the Supreme Court's mandate, the Circuit Court of Appeals reversed the judgment of the District Court on the merits. The opinion upon such reversal by Manton, *J.* is not yet reported.

The plaintiff now seeks by this petition a writ of certiorari to review the decree of reversal of the United States Circuit Court of Appeals, dated the 11th day of March 1935.

The subject matter of the suit is the promoting in 1930 by the defendants Maxime H. Furlaud and Carlos Reuter of the Duquesne Gas Corporation, of which the plaintiff is the ancillary receiver, and the public issue by defendants of $4,000,000 of bonds and $1,000,000 of notes of said corporation and the sale by them of a part of the stock of said corporation for $850,000.

The facts as found by the District Judge* and which (except as to one detail) are undisputed are, very briefly stated, as follows:

Acting through an incorporated banking house, known as Furlaud & Company (R. 318) which corporation after changing its name was dissolved before the commencement of this suit (R. 333, 155-6), the defendants Furlaud and Reuter caused their banking house to publicly circulate prospectuses covering the issue of the $4,000,000 of bonds and the $1,000,000 of notes, which stated in effect that the proceeds of the issue of these bonds and notes would be used for the purchase of the properties of Duquesne Gas Corporation and for the other corporate purposes of that corporation (R. 326, 263-71, 276-84). The transactions hereinafter related were personally supervised by the defendant Maxime H. Furlaud individually (R. 116, 130, 104,

*The opinion of the District Judge is printed at pages 318-337 of the record.

165). He was the president and chief stockholder of the dissolved corporation Furlaud & Company (R. 165, 157, 158).

Just prior to the issuance of the prospectuses, the defendants procured fraudulent and highly excessive appraisals representing a value of $7,038,000 for the natural gas properties which the Duquesne Gas Corporation was organized to acquire and operate (R. 319-20, 325-6). It was the use of these fraudulent appraisals which made it feasible for the defendants to consummate their fraud upon the Duquesne Gas Corporation and its creditors, the subscribers to the bonds and notes.

It was also found by the District Court that these properties, which cost $2,572,989 or about one-third of the amount of the fraudulent appraisals, were paid for out of the proceeds of the bonds and notes, out of the proceeds of which also came the $365,000 of working capital which, together with the gas properties, was all that the corporation ever received,—and all that its promoters ever intended it should receive,—out of the proceeds of the bonds and notes or for its stock (R. 325-6, 121).

As a result of the issuance of these prospectuses, these defendants through their banking house received $4,492,768.73 from the sale of the bonds and notes, of which they turned over to the Duquesne Gas Corporation or used for its benefit only the sum of $2,937,989.90. They misappropriated and converted to their own use the difference, viz. $1,554,788.83 (R. 325). This sum, with interest computed upon it to the time of the judgment, amounted to the sum of $1,834,640.08, which is the amount of the judgment granted (R. 339).

The corporation at its start had, therefore, an outstanding indebtedness of $5,000,000 represented by $4,000,000

of bonds and $1,000,000 of notes against which it had $2,937,989 of assets consisting of gas properties which cost $2,572,989 and cash working capital of $365,000. Its assets were therefore but 59% of its liabilities. *It was thus insolvent at its very start.*

The public offering was made by the defendants of the $4,000,000 of bonds on March 25, 1930 (R. 258). When about 75 or 80 per cent. of the bonds had been subscribed and the distribution of the bonds was an assured success (R. 111), a closing was arranged to be held at the Central Hanover Bank and Trust Company in New York on April 9, 1930.

Preparations for the closing had been made so as to have the muniments of title of the various gas properties executed and lodged in escrow in various banks in or near Pittsburgh, with provisions that sight drafts covering the purchase prices of the several properties would be lodged in correspondent banks in New York and that, upon the acceptance of such drafts covering the purchase price of the several optioned properties, the title deeds, which ran direct to Duquesne Gas Corporation, would be delivered to the representatives of the promoters (R. 117-119).

It was also arranged by the defendants that the subscribers to the bonds, consisting of forty or fifty distributing houses situated from the Atlantic to the Pacific coast, should have their representatives at the closing to take their bonds to which they had subscribed against payment by certified check (R. 119, 130).

This plan went off according to schedule.

Defendant Furlaud arranged with the Central Hanover Bank and Trust Company for a one day loan or credit, under the bank's strict control, upon the security of the $4,000,000 of bonds and $1,000,000 of notes which were

physically present at the closing (R. 130, 131). Telegraphic assurances were then sent of the acceptances of the sight drafts (R. 118). The mortgages securing the bonds and notes which had been executed were in the hands of the defendants' representatives in Pennsylvania and were thereupon immediately recorded along with the instruments of conveyance which were released from escrow by the Pennsylvania banks pursuant to the telegraphic notice of the acceptance of the drafts (R. 118). The certified checks which were received in payment of the subscriptions of the purchasers of the bonds were thereupon taken and the bonds delivered to the purchasers. A large queue of bank messengers was present and was kept waiting until about the end of the closing which occupied the larger part of the day (R. 105, 119, 130). The money thus received from the bondholders was then immediately applied toward the liquidation of the one day loan (R. 131).

The transactions at the closing were related by three witnesses who attended at the closing, namely: Krog, a former employe of the defendants, whom the defendants made vice-president of Duquesne Gas Corporation for the purpose of signing the bonds and notes and the other corporate records prepared by the defendants (R. 104-105); Duke, who was the attorney in charge of the proceedings at the closing (R. 116-122); and Osborne, who was the officer of the Central Hanover Bank and Trust Company representing the bank at the closing (R. 130-1). These several witnesses all testified to the effect above related and there is no evidence to controvert their testimony.

The opinion of the District Judge correctly sets forth the transactions at the closing.

The defendants created an elaborate set of corporate records in which they used six wholly owned dummy cor-

porations, viz.: Furlaud & Co. (dissolved), Kingston Corporation, Byron Corporation, Chaucer Corporation, Virgil Corporation and Kipling Corporation. These records were, in much, inconsistent with the actual transactions which transpired at the closing. To the extent that they were thus inconsistent with the actual facts these corporate records were fictitious.

The opinion of the Circuit Court of Appeals, seemingly, looks at the fictitious corporate records and overlooks the actual transactions which transpired at the closing and thus falls into a vital error in stating at several places in its opinion that, at the time of the closing, the defendants "owned all of the issued common capital stock of the Duquesne Gas Corporation and all of its bonds and notes." The opinion of the Circuit Court of Appeals is itself inconsistent with the foregoing quoted statement, for its opinion says that on the day of the closing the purchasers of the bonds, to the extent of about $2,350,000 in face amount, paid at the closing by certified check amounts, aggregating $1,886,330. It appears, therefore, from the Circuit Court of Appeals' opinion that bondholders, other than the defendants, to the extent of at least $2,350,000 in face amount had become such at the time of the closing and had then paid at least $1,886,330 which was used to pay for the gas properties then under option for the corporation.

The only material fact as to which there could be said to be conflicting testimony was as to the amount paid in at the closing by the innocent subscribers to the bonds. The plaintiff's proof showed that at the time of the closing the $4,000,000 bond issue had been subscribed to the extent of about 75 or 80 per cent. (R. 111), which, since the price was 96½ (R. 169), would go to show that

about $3,000,000 was paid in at the closing. The opinion of the District Judge so finds (R. 324). The defendants' sole witness Halporn testified to the above figures referred to in the opinion of the Circuit Court of Appeals. The Trial Judge did not choose to believe Halporn but chose rather to believe the other witnesses. The whole testimony of the witness Halporn (R. 162-182) demonstrates that it was quite proper for the Trial Judge to find as he did.

Presumptively, the Trial Court's findings were correct. *Kimberly* v. *Arms,* 129 U. S. 512, 524; 32 L. ed. 764, 769, 1889; *Brookheim* v. *Greenbaum,* 225 F. 763, C. C. A. 2nd 1915; *Dunn* v. *Trefry,* 260 F. 147, C. C. A. 1st 1919; *Benedict* v. *Setters,* 261 F. 492, C. C. A. 8th 1919; *Lackner* v. *McKechney,* 2 F. (2d) 516 C. C. A. 7th 1924; cert. denied 267 U. S. 601, 69 L. Ed. 808; *United States* v. *Mammoth Oil Co.,* 14 F. (2d) 705, C. C. A. 8th 1926, aff'd 275 U. S. 13, 72 L. Ed. 137.

The Appellate Court, although stating the facts quite differently from the findings of the Trial Court, nevertheless made no attempt to demonstrate that any of the findings were erroneous. Nor could such a demonstration have been made, for the reason that the undisputed evidence (except, possibly, as to the amount paid in by the bondholders at the closing) compelled the findings which were made by the Trial Court. Also the omissions of the Appellate Court's opinion as to important facts are, well-nigh, as serious as its misstatements. The Appellate Court reversed upon a false hypothesis.

The presumption of the correctness of the Trial Court's findings should be entertained in this Court notwithstanding the reversal by the Appellate Court.

Mason v. *U. S.*, 260 U. S. 545, 556; 67 L. Ed. 396, 400 (1923);
Adamson v. *Gilliland*, 242 U. S. 350, 353; 61 L. Ed. 356, 358 (1917).

Certainly, the Trial Court's findings upon the undisputed facts are unchallengeable. Whether or not the amount paid in at the closing by the bond subscribers, was, as found by the Trial Court, considerably larger, it is conceded by all that at least $2,350,000 in face amount of bonds had been subscribed for prior to that time and that at least $1,886,330 was then paid in by the subscribers, and that additional subscriptions were coming in daily, and that the whole $4,000,000 bond issue was subscribed and within a few weeks paid for in full by the subscribers.

The bonds were not issuable by the Duquesne Gas Corporation until the day of the closing. This is so for the simple reason that the corporate property was not conveyed to the corporation or the mortgage securing the bonds recorded until that date, at which time a very large amount of the bonds were delivered to the various innocent subscribers against payment in cash. These moneys were used to pay for the corporate properties in order thus to procure the conveyances to the corporation. This procedure required that the whole transaction be part of a simultaneous closing. There is not the slightest room for the conception, therefore, that the defendants ever owned, even for a moment, the bonds which were delivered to and paid for by the innocent subscribers at the time of the closing.

Apart from that, the securities of the Duquesne Gas Corporation, which is a Pennsylvania corporation, were void in the hands of the defendants under the constitution of that Commonwealth and the decisions of the Courts of

that Commonwealth and of the Federal Courts. *Art 16, Sec. 7 of the Constitution of the Commonwealth of Pennsylvania; Commonwealth* v. *Reading Traction Co.*, 204 Pa. 151, 53 A. 755; *Guarantee T. & T. Co.* v. *Dilworth Coal Co.*, 235 Pa. 594 (1912); *Bingaman* v. *Commonwealth Trust Co.*, 15 Fed. (2d) 119 (D. C. M. D. Pa. 1926); *In re Wyoming Valley Ice Co.*, 153 Fed. 787 (D. C. M. D. Pa. 1907); *Gearhart* v. *Standard Steel Co.*, 223 Pa. 385 (1909).

The million dollars of notes, above referred to, were received by the defendants at the closing without the payment of any consideration. The note prospectus, contained statements similar to the statements contained in the bonds to the effect that the proceeds of the issue were to be used for the purchase of properties of the Duquesne Gas Corporation and otherwise for the benefit of the corporation (R. 278, 280, 283). A few weeks after the successful flotation of the $4,000,000 of bonds, the notes were sold by the defendants for $861,097.69 in cash (R. 271, 108, 137).

Since the defendants had received as the proceeds of the bond issue the net sum of $3,631,671.04 (R. 136-7) and had misappropriated for their own use from such proceeds all but the purchase price of the properties which was $2,572,989 (R. 244) and the working capital which was $365,000 (R. 121), namely, they had then misappropriated $693,682.04, the sole purpose of the issuance of the notes was merely for the defendants to misappropriate the whole proceeds thereof which amount to $861,097.69.

This made the total misappropriation by the defendants of the proceeds of the bonds and notes $1,554,779.73. This amount with interest thereon, amounting in all to $1,834,640.08, was the basis of the judgment which the District Court awarded to the plaintiff (Final Decree, R. 339).

The defendants also received at the closing, without the payment of any consideration, 675,000 shares of the capital stock of the corporation 85,000 shares of which they sold through two dummy corporations, the defendants Byron Corporation and Chaucer Corporation, for the sum of $850,000 cash. This sale was made as an outright sale to a stock operator named Bergen (R. 137, 289). There was no proof as to what the defendants did with the remaining 590,000 shares of the capital stock. The denial by the District Court of the plaintiff's claim that defendants were also accountable for this sum of $850,000 constitutes the basis of the plaintiff's cross-appeal. The essential facts in respect of the handling by the defendants of this stock are sufficiently set forth in the opinion of the District Judge.

The Circuit Court of Appeals based its reversal upon the authority of the decision of the United States Supreme Court in *Old Dominion Copper Company* v. *Lewisohn* (C. C. A. Opinion page 7), 210 U. S. 206, 52 L. Ed. 1025. The Circuit Court of Appeals did not refer to or discuss the decision of the United States Supreme Court in *Davis* v. *Las Ovas*, 227 U. S. 80, 57 L. Ed. 426.

THE QUESTIONS PRESENTED

(1) Are the defendants entitled to immunity from accountability to the corporation under the authority of *Old Dominion Copper Company* v. *Lewisohn*? Is not the instant case distinguishable from the *Lewisohn* case?

(2) Does not the instant case fall within the authority of the *Davis* v. *Las Ovas* case instead of the *Lewisohn* case so as to make the defendants accountable to the corporation for the proceeds of the securities of the corporation which were received by them, because, at the closing of

the transaction for the purchase of the property, the very money of innocent subscribers for the bonds was applied to the payment for the corporate properties?

(3) Since the corporation was, through the fraudulent acts of the defendants rendered insolvent at its start, has not the plaintiff, in his capacity as receiver and standing in the right of the creditors, the right to disaffirm the acts of the corporation?

(4) Did not the statements which the defendant Furlaud caused to be inserted in both the bond and note prospectuses, to the effect that the proceeds thereof were to be devoted to the purposes of the corporation, constitute such representations as to the purpose for which the proceeds of the bonds and notes were to be used as to impress a trust upon such proceeds for the benefit of the Duquesne Gas Corporation?

(5) Was not the Duquesne Gas Corporation powerless, even with the consent of all of its stockholders, directors and officers, to render itself insolvent by surrendering to the defendants its right to hold them accountable to it for the proceeds which came into the hands of the defendants from the issuance of its securities?

(6) Is not the individual defendant Maxime H. Furlaud accountable in the place and stead of Furlaud & Company, since the defendant Furlaud individually supervised and conducted the transactions and caused Furlaud & Company which he dominated to make the wrongful misappropriations and breach of trust and thereafter cause the corporation Furlaud & Company, to be dissolved before the commencement of this suit?

REASONS FOR THE ALLOWANCE OF THE WRIT

(1) The decision of the Circuit Court of Appeals is clearly erroneous and most inequitable and unjust. The decision of the Supreme Court in *Old Dominion Copper Company* v. *Lewisohn* is not, as the Circuit Court of Appeals seems to hold, authority for the granting of immunity from accountability to the defendants as the promoters of the corporation for their fraudulent misappropriations, breaches of trust and secret profits. The instant case is distinguishable from the Supreme Court's decision in the case of *Old Dominion Copper Company* v. *Lewisohn* and more properly falls within the authority of the Supreme Court's later decision in *Davis* v. *Las Ovas*. This latter decision limits the scope of the case of *Old Dominion Copper Company* v *Lewisohn*. The Circuit Court of Appeals did not refer to the decision of the Supreme Court in the case of *Davis* v. *Las Ovas*, and it seems therefore that the Circuit Court of Appeals overlooked the proper effect to be given to that decision.

(2) Although the Circuit Court of Appeals, Second Circuit, in its decision in the case of *Ball* v. *Breed*, 294 Fed. 227, to which it also refers in its opinion herein as authority, applied *Old Dominion Copper Company* v. *Lewisohn* as authority for granting to promoters immunity from accountability, the Federal Courts in other Circuits have been more inclined to look upon the Supreme Court's decision in *Davis* v. *Las Ovas* as limiting the decision of *Old Dominion Copper Company* v. *Lewisohn*, and in several instances the Federal Courts in other Circuits have held promoters accountable to the corporation under the authority of *Davis* v. *Las Ovas* rather than as immune from accountability under the authority of *Old Dominion Copper*

Company v. *Lewisohn*. See: *Tilden* v. *Barber*, 268 Fed. 587 (D. C. N. J. 1920); *American Shipbuilding Co.* v. *Commonwealth S. S. Co.*, 215 Fed. 296 (C. C. A. 6th, 1914); *Dunlap* v. *Twin City Power Co.*, 226 Fed. 161 (C. C. A. 4th, 1915); *Humble Oil Co.* v. *Campbell*, 69 Fed. (2d) 667 (C. C. A. 5th, 1934). In other Federal cases referring to *Old Dominion Copper Company* v. *Lewisohn*, in which the promoters have been held not accountable, such as: *Ball* v. *Breed supra; South Penn Collieries Co.* v. *Sproul*, 52 Fed. (2d) 557, 561 (C. C. A. 3rd, 1931); *Johnson* v. *Louisville Trust Co.*, 293 Fed. 857, 861 (C. C. A. 6th, 1923), the decisions seem to be based more upon the fact that in those cases, the promoters' profits were not excessive or secret.

IMPORTANCE OF THE QUESTIONS

It is most important that this Court review the decision of the Circuit Court of Appeals, which seems to hold that the decision in *Old Dominion Copper Company* v. *Lewisohn* compels a determination that the defendants are entitled to immunity from accountability for their fraudulent acts as the promoters of the corporation in misappropriating the proceeds of the corporate securities. Reference to the reported decisions in both the federal and state courts shows that the Supreme Court's decision in *Old Dominion Copper Company* v. *Lewisohn* has been frequently invoked by fraudulent promoters as a shield against accountability, and, in some cases other than the instant case, has been applied with that effect (See Appendix). Even the District Judge, though impressed as his opinion shows with the grossly fraudulent character of the transactions, felt constrained by *Old Dominion Copper Co.* v. *Lewisohn* to hold defendants immune from account-

ability for the $850,000 received by them as the proceeds of a part of the stock.

It is to be feared that the decision of the Circuit Court of Appeals, if permitted to stand, will be taken as an authoritative interpretation of the *Old Dominion* case as a precedent that fraudulent promoters are immune from accountability even in grossly fraudulent transactions, such as those presented by the instant case.

It is important, therefore, that the Court should review the decision of the Circuit Court of Appeals in order to clarify the application of the *Old Dominion Copper Company* v. *Lewisohn* decision.

WHEREFORE, it is respectfully submitted that this petition for a writ of certiorari to review the decision of the Circuit Court of Appeals of the Second Circuit dated the 11th day of March, 1935 and the decree of the United States District Court for the Southern District of New York, dated the 11th day of May 1933, should be granted.

GEORGE W. MCCANDLESS,
as Ancillary Receiver of Duquesne Gas Corporation,

By RALPH ROYALL,
WILLIAM A. MAGEE and
CLARK MILLER,
Counsel for Petitioner.

April, 1935.

BRIEF IN SUPPORT OF PETITION

OPINIONS OF THE COURTS BELOW

The opinion of the District Court is reported in 4 Fed. Supp. 884 (Advance Sheets only) and is printed at pages 318-37 of the record. The first opinion of the Circuit Court of Appeals is reported in 68 Fed. (2d) 925. The opinion of the United States Supreme Court upon the prior appeal is reported in 79 Law. Ed. 32. The second opinion of the Circuit Court of Appeals is not yet reported.

JURISDICTION

The jurisdiction to issue the writ is found in Sec. 240-a of the Judicial Code as amended by the Act of February 13, 1925, c. 299, Sec. 1, 43 Stat. 938; Sec. 347-a of Title 28, U. S. C.

STATEMENT OF FACTS

The statement of facts set out in the foregoing petition is hereby adopted and is supplemented as follows:

The bond prospectus issued by the defendants contained the following:

"SECURITY

The appraisals of the engineers covering the properties of the Corporation, including working capital of $365,000, aggregate $7,038,000 (R. 266).

* * * * * * *

CAPITALIZATION

	Authorized	Outstanding
First Mortgage 6% Convertible Gold Bonds (this issue)	$4,000,000	$4,000,000
Convertible 6½% Secured Gold Notes	1,000,000	1,000,000
Common Stock (no par value)	1,250,000 Shs.	675,000 Shs.

(R. 267)

* * * * * * *

PURPOSE OF ISSUE

These bonds are issued by the Corporation in connection with the acquisition of properties and to provide cash for developments, extensions and other corporate purposes" (R. 270).

The note prospectus contained similar statements under similar captions (R. 277-284).

SPECIFICATION OF ERRORS

1. The Circuit Court of Appeals erred in reversing the decree dated the 11th day of May, 1933, and in dismissing the complaint.

2. The Circuit Court of Appeals erred in refusing to modify the decree dated the 11th day of May, 1933, by adding to the amount of the judgment against defendants Furlaud and Kingston Corporation the sum of $850,000 with interest, and directing that judgment also be entered against defendants Byron Corporation and Chaucer Corporation in the sum of $425,000 with interest.

ARGUMENT

I

The prospectuses plainly were intended to induce the belief in those whose subscriptions to the bonds and notes were solicited that, not only the whole net proceeds of the bond and note issues were to be made available by the bankers to the corporation for the acquisition of the corporate properties and for working capital and other corporate purposes, but that in addition the 675,000 shares of issued stock represented some very substantial contribution to capital of not less than the difference between the $5,000,000 represented by the bonds and notes and the $7,038,000 stated by the prospectus to constitute the assets.

Corporate bonds are, of course, not looked upon favorably unless there is some equity in the property beyond the amount of funded debt. It is quite apparent that the whole prospectus was designed to convey the belief that the corporation was set up with a real capital of $7,000,000 and that, therefore, not only the whole proceeds of the bonds and notes, but some very substantial amount representing the outstanding stock was to be made available to the corporation.

These prospectuses must be interpreted according to the impression which they convey rather than upon a too narrow and literal construction. *Aaron's Reefs* v. *Twiss* (L. R. App. Cas. 1896), 273, 285, opinion of Lord Halsbury; *Downey* v. *Finucane*, 205 N. Y. 251; *Gates* v. *Megargel*, 266 Fed. 811.

Certainly, the prospectuses were not intended to induce the belief in those whose subscriptions for the

bonds and notes were solicited that the proceeds of these issues were to a large extent to be misappropriated by the promoters, and that the new corporation was actually to receive less than $3,000,000 from the issuance of all its securities, and thus be hopelessly insolvent at the start. The bondholders and noteholders must have intended that the proceeds of their subscriptions were to be used for the benefit of the corporation. The defendants well knew this, for the simple reason that the prospectuses which they issued induced in the subscribers to the bonds and notes this belief.

Where one delivers money to another with the intention that that other shall pay the money to a third person, a trust arises which may be enforced by that third person. *McKee* v. *Lamon,* 159 U. S. 317, 322; *Sayer* v. *Wynkoop,* 248 N. Y. 54; 2 Storey's Equity Juris. (12th Ed.), Sec. 1255; 26 R. C. L. 1235, Sec. 82.

The corporation's beneficial interest in the proceeds of the bonds and notes constituted a property right which the corporation was powerless, even with the consent of all its stockholders, directors and officers, to give away, thus rendering the corporation insolvent. Fletcher Cyclopedia of Corporations, Permanent Edition, Sec. 7407.

The stockholders may not take the corporate assets even as against prospective creditors, and, in such circumstances the receiver or trustee of the corporation may recover. *Coleman* v. *Tepel,* 230 Fed. 63, 71 (C. C. A. 3rd, 1916).

The misappropriation by the defendants of a large part of the proceeds of the bonds and notes was a conversion of the property of the corporation, and a fraud upon its creditors. The receiver has the right to recover for this conversion of the corporate funds.

It is a distortion of the case of *Old Dominion Copper Company* v. *Lewisohn* to treat it as the Circuit Court of Appeals did, as authority for the granting of immunity from accountability for this wrongful misappropriation.

Although no representations were made in respect to the stock such as were made in respect of the bonds and notes from which a trust for the corporation arose, nevertheless the courts below erred in not also awarding additional judgment to the plaintiff for the sum of $850,000 received by the defendants as the proceeds of the sale of part of the stock.

The relation of the defendants,— the promoters—to the corporation, was of a fiduciary character. *Yeiser* v. *United States Board & Paper Co.*, 107 Fed. 340 (C. C. A. 6th, 1901); *Humble Oil Co.* v. *Campbell*, 69 Fed. (2d) 667 (C. C. A. 5th, 1934).

Even assuming that the defendants owned all of the capital stock of the corporation at the time of the closing of the transaction, still, in the situation presented by the instant case, they were not free to deal with the corporation as they wished, and as though it were their own.

Where, as here, the corporation is created as an insolvent corporation by its promoters, the position of the creditors overshadows the position of the stockholders.

In the instant case there were bondholders to the extent of at least $2,350,000 in face amount,—the Trial Court found there were considerably more,—who had become such at the time of the closing.

The theory of *Old Dominion Copper Company* v. *Lewisohn* case is summed up in two sentences of the Supreme Court's opinion (210 U. S. 212):

> "At the time of the sale to the plaintiff, then, there was no wrong, to anyone. Bigelow, Lewisohn,

> and their syndicate were on both sides of the bargain, and they might issue to themselves as much stock in their corporation as they liked in exchange for their conveyance of their land."

This indicates the deep and wide distinction between that case and the instant case. In the instant case defendants were not upon both sides of the bargain. On the other side of the bargain at the time of the closing were the creditors of this insolvent corporation; namely the bondholders who had become such at the time of the closing. Furthermore, the stock of the corporation was not in the instant case exchanged for a conveyance by the defendants of their property. In fact, no property of the defendants was exchanged for the stock. The property here involved was paid for directly to the original owners with the proceeds of the bonds and notes.

Old Dominion Copper Company v. *Lewisohn* has been distinguished and limited by the later decision in *Davis* v. *Las Ovas Co.*, 227 U. S. 80; 57 L. Ed. 426. In the latter case the property was purchased by a syndicate and resold to the corporation. Unknown to some of their associates in the syndicate the promoters obtained an option to purchase the property for themselves at a lower price, with the result that the corporation was required to pay a secret profit to the promoters. The Supreme Court held that, as the innocent members of the syndicate were to become stock subscribers and directors of the company, the buyers and sellers were not the same, and that the distinction between this and a case in which all of the owners of the property and all of the members of the buying corporation are the same persons and participate in the profit was fully recognized in the *Lewisohn* case. The Supreme Court affirmed a judgment in favor of the plaintiffs. The case is

clear authority for the proposition that the rule of the *Lewisohn* case applies only where there are no innocent persons involved at the time of the transaction, that is when all parties in interest participate in the profit. This court also pointed out that the corporate right of action was not defeated by the fact that the recovery would inure to the benefit of the guilty as well as the innocent. The court also said:

> "The standing of the corporation results from the fact that there were innocent and deceived members of the corporation when the property was taken over by it."

Certainly the instant case presents a much stronger case than *Davis* v. *Las Ovas* for the application of the doctrine of that case. In the instant case the payment over to the corporation of the defendants' whole secret profit will redound wholly to the defrauded creditors of this insolvent corporation.

Certainly, the plaintiff herein as receiver stands in the rights of these creditors. *Casey* v. *Cavaroc*, 96 U. S. 467, 488; *Atlantic Trust Co.* v. *Chapman*, 208 U. S. 360.

The *Las Ovas* case and the cases following it generally deal with situations in which there were innocent stockholders.

The case of *Johnson* v. *Louisville Trust Company*, 293 Fed. 857, 861 (C. C. A. 6th, 1923), as well as some other cases which have applied the *Old Dominion* v. *Lewisohn* case suggest that the existence of innocent creditors is sufficient. The Court said, speaking of the *Las Ovas* rule:

> "* * * such rule would scarcely seem applicable * * * for nothing seems to have been done to mislead or deceive prospective creditors."

The cases of:

Hoffman Motor Truck Co. v. *Erickson,* 124 Minn. 279 (1914);

Inland Nursery & Floral Co., v. *Rice,* 57 Wash. 67 (1910);

Vasey v. *Coal Co.,* 89 W. Va. 499 (1921);

Coleman v. *Tepel,* 230 Fed. 63, 71 (C. C. A. 3rd, 1916).

are to similar effect.

There is much to be said, broadly speaking, for such a suggestion. On the other hand there is authority to the contrary, such as the case of *Allenhurst Park Estates* v. *Smith,* 101 N. J. Eq. 581 (1927), which is cited in the opinion of the Circuit Court of Appeals.

But, in respect of an *insolvent* corporation, there is, we submit only one possible view open to a Court of Equity. In the case of such a corporation the creditors have the sole interest in the affairs of the corporation. The interest of the stockholders is purely technical and formal. The case of *Allenhurst Park Estates* v. *Smith,* and any others to similar effect, which we have seen are cases in which the corporation was amply solvent.

It is unthinkable that the Courts of Equity should countenance a view that promoters may deal as they please with the corporations in their control, even to the extent of misappropriating the creditors' money and rendering the corporation insolvent. As stated by the Trial Court

> "* * * simple justice requires that the receiver, in his representative capacity, should be able to vindicate the rights of creditors who were victimized. If

> a court of equity is to function within the domains of conscience, and if it is to redress the wrongs that occur within that dominion, it must provide a remedy that is capable of check-mating the ingenuity that here perpetrated a grievous wrong." (Opinion of Judge Knox, R. 333.)

These defendants did not have the least right to appropriate any of these securities, or the proceeds of them, and should have been held accountable for all. This conclusion follows general rules which are well recognized in Courts of Equity and is reenforced by Art. 16 Sec. 7 of the Pennsylvania constitution which makes all of these securities void in the hands of these defendants.

II

The individual defendant Maxime H. Furlaud was properly held by the District Court to be accountable for the misappropriated moneys. He personally arranged and supervised the transactions. Although the affairs for which he was held responsible by the Trial Court were to a large extent carried on in the name of Furlaud & Company, Maxime H. Furlaud was nevertheless the president and chief stockholder of that corporation and dominated it. After the fraudulent misappropriations were committed, the individual defendant Maxime H. Furlaud caused that corporation first to change its name and then to dissolve.

One may not cause a corporation which is under his dominion to commit a breach of trust without himself becoming accountable for the consequences. *Anderson* v. *Daley*, 38 App. Div. 505 (Appeal dismissed 159 N. Y. 146).

CONCLUSION

It is submitted that it is most important that this Court should review the application of its decision in *Old Domin-*

ion Copper Company v. *Lewisohn* with respect to situations, such as the instant one, in which fraudulent promoters and bankers claim,—under what they assert to be a correct construction of that case,—immunity from accountability for fraudulent misappropriation. It is also submitted that the decision of the Circuit Court of Appeals is most inequitable and unjust and that the writ should be granted.

Respectfully submitted,

RALPH ROYALL,
WILLIAM A. MAGEE and
CLARK MILLER,
Of Counsel.

APPENDIX

The decision in *Old Dominion Copper Mining and Smelting Company* v. *Lewisohn*, 210 U. S. 206 (1908), and the other decisions of the Federal and State Courts since that time dealing with the subject.

The litigation growing out of the promotion of the Old Dominion Copper Mining and Smelting Company took a varied course. The corporation itself (there was no receivership) brought two suits which, except as to the defendants named, were identical. One was the suit instituted in the Federal court in New York against Lewisohn, one of the alleged fraudulent promoters, which resulted in the determination by the Supreme Court in 210 U. S. 206. The other was a suit brought in the State courts of Massachusetts against Bigelow, who was Lewisohn's associate as promoter. The Supreme Court of the United States held that the corporation had no right of action against its promoters to recover for a secret profit, since they owned all the stock of the corporation at the time of the transaction and were thus on both sides of the bargain, even though it was contemplated at the time that others should become stockholders by original subscription without knowledge of the secret profit. The Supreme Court of the State of Massachusetts (203 Mass. 159) reached the directly opposite conclusion. In a suit brought in New Jersey seeking to enjoin the corporation from pursuing Bigelow, the Supreme Court of New Jersey (74 N. J. Eq. 457) preferred to take the view of the Massachusetts court; and the United States Supreme Court itself in a later decision, 225 U. S. 111 (1912) refused to require the Massachusetts court to conform to the Supreme Court's decision. Thus

while one of the joint promoters of the Old Dominion Company escaped liability in the Federal courts, his fellow promoter was finally held liable by the Massachusetts courts.

These suits and the several phases of them in the United States, Massachusetts and New Jersey courts are reported as follows:

188 Mass. 315 (1905);
203 Mass. 159 (1909);
74 N. J. Equity 457 (1908);
136 Fed. 915 (1905);
210 U. S. 206 (1908);
225 U. S. 111 (1912);
195 Fed. 637 (1911);
202 Fed. 178 (1913).

The two latest decisions above referred to in the Federal courts involved a continuation of the same action after amendments to the complaint had been made. A brief history of the several suits and decisions growing out of the transaction is given by Judge Hough in 195 Fed. 637 (1911). Although Judge Noyes in the Circuit Court of Appeals (202 Fed. 178) indicated that he thought the amended complaint stated a cause of action in spite of the previous decision of the Supreme Court of the United States, recovery was denied on principles of estoppel and *res adjudicata*. (Writ of Cert. denied, 229 U. S. 613 (1913).)

The Supreme Court subsequently clarified and strictly limited the general application of the doctrine of the *Lewisohn* case in *Davis* v. *Las Ovas Co.*, 227 U. S. 80 (1913). There one of the members of a syndicate, organized for the promotion of a corporation, made a secret profit in the trans-

action, thus injuring the other members of the syndicate who also were to become stockholders. It was held that a right of action for this fraud vested in the corporation. It was further held that the corporate right of action could not be defeated by the fact that the recovery would inure to the benefit of the guilty as well as the innocent. The Court made it clear that the *Lewisohn* case should not be applied in situations in which any innocent parties are affected. It is to be especially noted that in this case the Supreme Court referred with particular approval to the decision made by the Circuit Court of Appeals of the 6th Circuit in the year 1901, in the case of *Yeiser* v. *U. S. Board & Paper Co.*, 107 Fed. 340 (C. C. A. 6th, 1901), as well as to the leading English case of *New Sombrero Phosphate Co.* v. *Erlanger*, L. R. 5 Chan. Div. 73. The Supreme Court said at page 87:

> "The distinction between a case in which all of the owners of the property and all of the members of the buying corporation are the same persons, and participate in the profit realized, and the case here presented, is fully recognized in *Old Dominion Copper Mining & Smelting Co.* v. *Lewisohn*, as well as in *New Sombrero Phosphate Co.* v. *Erlanger*, L. R. 5 Ch. Div. 73, 46 L. J. Ch. N. S. 425, 36 L. T. N. S. 222, 25 Week. Rep. 436, and in the well-considered opinion of Judge Severens in *Yeiser* v. *United States Board & Paper Co.*, 52 L. R. A. 724, 46 C. C. A. 567, 107 Fed. 340."

The extent of the limitation placed by the *Las Ovas* case upon the *Old Dominion* case is shown by the following language from the "well considered opinion of Judge Severens in *Yeiser* v. *United States Board & Paper Co.*," which the Supreme Court adopts as shown by the quotation above. Judge Severens says (107 Fed. 340, 344):

> "It is a well-settled principle of equity that those who participate in bringing about the organization of an incorporated company, and in getting it in condition for transacting the business for which it is organized, assume the obligations of a *trustee* towards the company and *those who shall be invited* to come into the enterprise as stockholders and share in ~~its~~ fortunes."

The English case of *New Sombrero Phosphate Co.* v. *Erlanger*, which as shown above, was expressly approved by the Supreme Court of the United Staets in *Davis* v. *Las Ovas*, was a case in which the promoters owned all the stock of the corporation at the time they made a secret profit on the sale of property to the corporation. The concealment in the prospectus sent to its future security holders was held to give the corporation a right of action for the fraud. Jessel, *M.R.* said at page 112:

> "Now, understanding, as I do, that the promoters of a company stand in a fiduciary relation to that company which is their creation; in this case that is emphatically so, for up to this time there was not really a single *bona fide* shareholder distinct from the promoters."

and on page 123:

> "* * * the syndicate, as promoters, being in a fiduciary relation to the company, it was essential that the public, who were invited to become, and who were expected to become, the shareholders of the company, and to constitute the company, should have the fullest information as to all the surrounding circumstances."

Since the *Lewisohn* case was decided by the Supreme Court fraudulent promoters have attempted many times to

invoke its doctrine in order to escape liability. The Federal courts as a rule, however, have distinguished that case and followed the *Davis* v. *Las Ovas* case. The following are such cases:

In *Tilden* v. *Barber,* 268 Fed. 587 (D. C. N. J. 1920), the promoters were held liable to the corporation though they owned all the stock at the time of the transaction with the corporation. This result was reached on the theory that the promoters were in the position of trustees to subscribers who were to be future stockholders of the corporation. The court at page 598 quoted the foregoing language from *Yeiser* v. *U. S. Board & Paper Co.*

The Court of Appeals in the 6th Circuit again invoked this trust doctrine in *American Shipbuilding Co.* v. *Commonwealth S.S. Co.,* 215 Fed. 296 (C. C. A. 6th, 1914). It was there said that when the promoters commenced their negotiations for the organization of the company, they were acting as trustees for the future corporation and its stockholders. The same result was reached in *Dunlap* v. *Twin City Power Co.,* 226 Fed. 161 (C. C. A. 4th, 1915).

In *Humble Oil Co.* v. *Campbell,* 69 Fed. (2d) 667 (C. C. A. 5th, 1934), which is the latest decision of the Federal courts upon the subject, the defendant issued and sold certificates of interest in certain oil properties owned by him and represented that all the proceeds would be turned over to the unit holders. In violation of the trust thus created the defendant sold a portion of the property and retained the proceeds. A corporation was organized to take over the property and the unit holders subsequently became shareholders in the corporation. In this suit by the receiver of the corporation it was contended that, under the doctrine of the *Lewisohn* case, no right of action existed in favor of the receiver. But the court held that the defend-

ant occupied a fiduciary relation to the unit holders and the future corporation, that where such a relationship exists the corporation may follow and gather in the trust property in spite of the rule of the *Lewisohn* case.

The Federal cases which applied the *Lewisohn* case in denying a recovery by the corporation, can, we believe, be distinguished on the ground that no fraud was actually practised by the promoters. These are the cases of *Ball* v. *Breed*, 294 Fed. 227, 231 (C. C. A. 2d, 1923); *South Penn Collieries Co.* v. *Sproul*, 52 Fed. 2d 557, 561 (C. C. A. 3rd, 1931); *Johnson* v. *Louisville Trust Co.*, 293 Fed. 857, 861 (C. C. A. 6th, 1923).

The question involved in the *Old Dominion* cases has arisen many times in the State courts of the country. The State courts have frequently discussed the conflict between the Massachusetts decision in the *Bigelow* case and the U. S. Supreme Court decision in the *Lewisohn* case and in most cases have preferred to follow the Massachusetts decision or the Supreme Court's *Las Ovas* decision. Such cases are the following:

Calif. *California Mining Co.* v. *Wells*, 170 Calif. 285 (1915);

Ken. *Datillo* v. *Roaten Creek Oil Co.*, 222 Ky. 378 (1927);

Maine *Land Co.* v. *Lewis*, 101 Me. 78 (1905);

Mich. *Torrey* v. *Toledo Portland Cement Co.*, 158 Mich. 348 (1909);

American Forging Co. v. *Wiley*, 206 Mich. 664 (1919);

N. J. *Arnold* v. *Searing*, 78 N. J. Eq. 146 (1910);

Bigelow v. *Old Dominion Copper Mining & Smelting Co.*, 74 N. J. Eq. 457;

Ore. *Wills* v. *Nehalem Coal Co.*, 52 Ore. 70 (1908);
Rugger v. *Mt. Hood Electric Co.*, 143 Ore. 193 (1933);
R. I. *Anderson* v. *Johnson*, 45 R. I. 17 (1923);
S. D. *Meier* v. *Eaton*, 46 S. D. 286 (1923);
Wisc. *Pittsburg Mining Co.* v. *Spooner*, 74 Wisc. 307 (1889);
Pietsch v. *Milbrath*, 123 Wisc. 647 (1905);

See also:

Ariz. *Frame* v. *Mahoney*, 21 Ariz. 282 (1920);
Conn. *Yale Gas Stove Co.* v. *Wilcox*, 64 Conn. 101 (1894);
Ga. *Downey* v. *Byrd*, 171 Ga. 532 (1930);
Mo. *South Joplin Land Co.* v. *Case*, 104 Mo. 572 (1891);
Pa. *Densmore Oil Co.* v. *Densmore*, 64 Pa. St. 43 (1870).

Such, also, is the view of the English Courts:

New Sombrero Phosphate Co. v. *Erlanger*, L. R. 5 Ch. Div. 73, 46 L. J. Ch. N. S. 425, 36 L. T. N. S. 222, 25 Week. Rp. 436 (opinion of Jessel, *M.R.*);
Gluckstein v. *Barnes* (1900) App. Cas. 240 (opinion of Lord Macnaghten).

Only a few of the states have indicated a preference for the *Lewisohn* decision.

See:

Colo. *Lilylands Canal Co.* v. *Wood*, 56 Colo. 130 (1913);

Minn. *Hoffman Motor Truck Co.* v. *Erickson,* 124 Minn. 279 (1914);

Wash. *Inland Nursery & Floral Co.* v. *Rice,* 57 Wash. 67 (1910);

W. Va. *Vasey* v. *Coal Co.,* 89 W. Va. 499 (1921).

But even in those jurisdictions which have approved the rule of the *Lewisohn* case, the courts have recognized that, where the rights of creditors are involved, the result may be different. See particularly:

Hoffman Motor Truck Co. v. *Erickson,* 124 Minn. 279 (1914);

Inland Nursery & Floral Co. v. *Rice,* 57 Wash. 67 (1910);

Vasey v. *Coal Co.,* 89 W. Va. 499 (1921);

Johnson v. *Louisville Trust Co.,* 293 Fed. 857, 861 (C. C. A. 6th, 1923).